Shamshad Akhtar: Perspectives on Pakistan's monetary policy developments

Address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, as chief guest at the Woodrow Wilson Centre, Washington DC, 24 April 2006.

The references for the speech can be found on the State Bank of Pakistan's website.

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I. Introduction

In line with trends world-wide, Pakistan adopted liberal and market-oriented monetary policies and procedures in the 1990s. This involved a move to indirect tools of monetary policy management and a major departure from the age-old practice of relying on direct interventions, such as liquidity reserve ratios and credit ceilings and controls. Accompanying this policy change were gradual changes to the legal and institutional framework of monetary policy formulation, its targeting and operating procedures as well as development of infrastructure for treasury operation to allow for effective open market operations.

These changes have had a subtle but profound impact on monetary management which in turn has impacted economic management of Pakistan. Like in several other places, there however remains a level of ignorance regarding the virtues and technicalities of monetary policy management and there is a debate on some key issues. Academics often question the relevance of policy goals and tools because of their different ideological stances and positioning. Structuralists doubt whether monetary policy has any significant impact, in particular on price stability. Frustrations are also evident among different economic players who are forced to change their behaviors and expectations in line with tighter monetary discipline and interest rate adjustments. There is less understanding and patience for the lagged effects of monetary policy to defuse the inflationary pressures or to ease the liquidity conditions.

Recognizing the concerns and debate, Pakistan's central bank regularly reviews the monetary policy in line with the evolving changes in the structure and workings of financial markets as well as in the broader economic and political environment. Since the mid-1990s, State bank has further strengthened the market-orientation of policy implementation, cut reserve requirements, developed open market operations, increased the flexibility of liquidity management, sharpened the focus on interest rates while maintaining reserve money as the operating target, improved the transparency of policy signals and shortened the maturity of interest rates serving as the fulcrum of policy.

I propose to initially provide few perspectives on the evolution of monetary policy, its challenges and practical difficulties in its implementation and then share with you the monetary policy outlook for 2006 and finally lead into a discussion of some of the complications and challenges in the conduct of monetary policy.

II. Policy, legal and institutional improvements in monetary management

Monetary policy of Pakistan now for some years has been largely supportive of the dual objective of promoting economic growth and price stability. It achieves this goal by targeting monetary aggregates (broad money supply growth as an intermediate target and reserve money as an operational target) in accordance with real GDP growth and inflation targets set by the Government.

Qualitatively monetary policy formulation and its implementation has improved substantially, benefiting from the following actions.

- First, legislative changes to the State Bank of Pakistan Act has empowered the SBP and SBP Central Board to formulate, conduct and implement its monetary policy
- Second, a Monetary and Fiscal Board has been set up to ensure formal monetary and fiscal policy coordination and this Board is currently chaired by the Prime Minister in his capacity as Finance Minister with representation from economic ministries.
- Third, the *Fiscal Responsibility and Debt Limitation Act* 2005 mandates a steady reduction in revenue deficit to zero by 30th June 2008 and maintaining it thereafter, and reducing total public debt to sixty percent of GDP by 2013 and below that limit thereafter.

These two principal steps lay the foundation for reducing fiscal subservience of monetary policy that for years served to complicate monetary management and allowed the Government unlimited recourse to low and fixed interest rate financing.

- Fourth, SBP continues to refine the institutional mechanism for monetary policy formulation and its regular review. For instance, SBP has replaced the Open Market Policy and Review Committee by the Monetary and Exchange Rate Policy Committee. This Committee meets bimonthly to establish parameters of broad monetary policy and reviews monetary and economic conditions on a regular basis and recommends changes in monetary policy instruments.
- Fifth, SBP Treasury's capacity has been strengthened to manage financial markets and related activities more effectively. Proactive conduct of monetary operations and management of market volatility has helped improve market flows. The Open Market Operation (OMO) process has been institutionalized with better flexibility vis-à-vis tenors and frequency. From 1995 - 2005, SBP's monetary operations were focused on T-Bill Auctions and predetermined schedule of weekly OMOs of fixed tenors with no forecasting capability of market liquidity. This resulted in a high degree of volatility in Overnight (O/N) & Shortterm Money Market rates. During 2005, SBP Treasury introduced the Money Market Computerized Reporting System (MM-CRS) for banks which helped in not only assessing the market liquidity, but to improving the grip on market gaps and interbank activity, thus strengthening the market management capability and SBP's forecasting capacity.

  Between Apr-Dec 2005, not only OMOs have been conducted both ways, but with a greater flexibility of tenors and frequency. Additionally, being active in the Swap Market has helped SBP Treasury to mop-up/inject USD/Rupee liquidity in the money market, as and when required, thus complementing the monetary management. This has resulted in managing excessive market volatility, providing effective signals/direction to the market and to set benchmarks for the rupee inter-bank market in line with the monetary policy stance. Consequently, O/N Rates now move within a 100bp – 150bp range compared to previous trends when it fluctuated between zero to 9.0%.

III. Monetary outlook for 2006 and associated challenges.

Current fiscal year is an important departure from the preceding few years’ monetary stance and trends observed. After 3-4 years of lax monetary policy, Pakistan faced significant monetary overhang since the growth in broad money supply every year exceeded the growth in nominal GDP.

Since the second quarter of 2005 monetary policy was tightened as the headline inflation, measured by Consumer Price Index (CPI), reached close to 11.1 in April 2005 - edging beyond the yearly target of 8% with Wholesale Price Index (WPI) pointing to the risk of moving to double digits. It has to be further recognized that given structural issues, the inflation threshold for developing countries is high - inflation in excess of 8- 12% is found to hurt economic growth.[1]

To start off, SBP raised discount rate to 9% in April 2005 which generated an uptrend in interest rates on T-bills auctioned and sharpened its yield curve: 3 months Tbill rate rose from 4.3 % Jan 05 to 8.1% by mid April 2006, 6 months 4.3% to 8.3% and one year from 5% in early 05 to 8.8%.

Has this monetary tightening achieved the desired results i.e. of curbing inflationary pressures? Latest trends of CPI are comforting but reveal different levels of deceleration across CPI categories and point to lingering concerns whether the deceleration will continue and/or if the decline in CPI and its components is there to stay. Some numbers are illustrative of this concern.

- While CPI had dropped to 6.9% YOY by March 2006 (compared to 10.2% recorded in the same month last year) with food inflation falling to 5.4% (compared to 13.3% in March 2005), the level of decline in nonfood inflation has been modest at 8.0% (compared to 8.2% in March 2005).

[1] Khan, S. Mohsin and Abdelhak, S. Senhadji: *Threshold Effects in the Relationship Between Inflation and Growth.* IMF Staff Papers, Volume 48, Number 1, June 2001.

- While month to month comparison point to sharper decline in inflation rate, the period average CPI and 12 month moving average CPI are still at 8.2% and 8.6%, respectively which is above the target inflation rate of 8%.
- The core inflation (measuring the non-volatile components) however confirms the deceleration in inflationary pressure as core CPI was down to 6.7% in March 2006 relative to 7.6% in March FY05 and the decline is 6.1% (compared to 8.0% in March 2005), if 20% trimmed mean is calculated.

IV. Realities and complications facing monetary policy

In evaluating the effectiveness of the monetary stance on inflation there is need to recognize some economic realities and complications which eventually help in developing an appropriate policy response.

Inflation, growth and financial development Nexus: MOHSIN S. KHAN AND AXEL SCHIMMELPFENNIG (2005)[2] conclude an inverse relationship between inflation and real per capita GDP: when inflation was 8 percent on average during 1978-1991, per capita growth averaged 3 percent but when inflation rose to 11% during 1992 and 1997 real per capita growth averaged only 1 percent and it further recovered as inflation fell to 5 percent. Further this study concludes that

"the direct inflation-growth nexus suggests a threshold in the range of 4 to 9 percent, while the inflation-financial development nexus suggests a lower threshold of 3– 6 percent….. Based on this, it is further recommended that SBP adopts an inflation target of 5 percent." This evidence has been arrived at based on empirical evidence of a number of studies: For instance:

- In a panel of 140 countries, Khan and Senhadji (2001) estimate inflation threshold to be 1–3 percent for industrial countries and 7–11 percent in developing countries.
- Focusing on Middle East and Central Asian countries including Pakistan, Khan (2005) estimates the optimum inflation rate to be 3 percent and argues that policy-makers should keep inflation below 6 percent to avoid a negative impact on growth.
- Mubarik (2005) using time-series data for Pakistan from 1973 to 2000[3] finds that inflation in excess of 9 percent harms short-run growth in Pakistan.
- Hussain (2005) estimates thresholds of 4–6 percent beyond which inflation adversely affect growth.

Furthermore, inflation hurts growth by making financial intermediation costly as high interest rates raise costs and lower long-run real returns for the corporate sector, while introducing adverse selection and moral hazard problems.

Lags in transmission mechanism. Empirical evidence indicates that there is a 6-24 months time lag in developing economies in the transmission of monetary policy impact on aggregate demand. In Pakistan, studies point that this lag is in the range of 12-18 months. It is because of this that the tolerance level of the economy for the fairly accommodative and easy monetary policy adopted over FY00-04 was remarkable as inflation remained low over this period with an average level of 3.9%. Admittedly, fiscal borrowing pressures during this period being low also provided scope for private sector credit growth.

However, monetary overhang of few years of accommodative monetary policy finally generated inflationary pressures which remained entrenched for some period. Consequent monetary tightening, now in place for over one year, is eventually showing signs of transmission channels working as evident from CPI deceleration.

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[2] Mohsin S. Khan and Axel Schimmelpfennig: *Inflation in Pakistan: Money or Wheat?* Paper presented in SBP conference, November 2005.

[3] The authors use the Hodrick-Prescott filter to reduce volatility in the data which potentially removes relevant information. Furthermore, in a single country case, the threshold will be restricted to be within the range of inflation experienced by that country.

An SBP Working Paper on the transmission mechanism of monetary policy[4] studies the relative importance of four channels through which monetary policy shocks are transmitted in Pakistan. While other transmission channels have yet to fully manifest themselves, banks have been observed to play a major role in the transmission mechanism with private sector credit as the leading indicator. But monetary policy transmission mechanism of this channel is weak because of the low impact of the interest rate channel, and also because the transmission mechanism cannot be developed on the basis of the short end of the yield curve, it needs a spectrum of rates in order to develop further, and the government has kept closed the long-term rate structure by holding off PIB auctions. Going forward, we need to work on strengthening the transmission mechanism by (a) further strengthening the banking sector, and (b) developing the market and the long-term yield curve.

Is inflation a structural supply side or monetary phenomena? While supply side factors do play a role in short term, inflation is always a long-term monetary phenomenon driven by demand pressures.

Inflation trends follow broad money growth and private sector credit growth closely with a lag of about 12 months and above. Given these factors, (i) SBP monitors CPI food and non-food inflation and (ii) two core inflation indictors that (a) excludes all volatile components and constitutes principally of a non-food and non-energy index and (b) another is derived as 20% weighted trimmed mean.[5] While (i) reflects overall price trends, the main driver for monetary policy is the core inflation.

On the supply side, price behavior is impacted by structural impediments facing the agriculture and industry sector which ranges from year to year fluctuations in crops and industrial capacity, distributional problems and sometimes hoarding practices. In Pakistan, supply factors influence 55% of CPI which accounts for three commodity groups (i.e. food and beverages, fuel and lightening and transport and communication) and food alone accounts for 40.3% of CPI and wheat (and wheat flour) has a weightage of 5.7%.

Is inflation a fiscal phenomenon. Studies for Pakistan have confirmed that excessive government's recourse to the central bank for financing fiscal deficit is inflationary in the long-run and complicates monetary management and its implementation. Fiscal deficit has a direct impact on inflation as government expenditure constitutes a large part of aggregate expenditure that might lead to demand pull inflation, and an indirect impact as the fiscal deficit is financed partly through central banks. With the reduction in fiscal deficit in recent years, both the direct and indirect impacts of deficit have been low and headline inflation remained low.

Exception to this is FY06 when fiscal pressures have been stronger partly because of the unanticipated earthquake spending but more significant because of the inherent weaknesses in the structure of taxes as the tax/GDP ratio has been low.

These trends have interrupted compliance with the Fiscal Responsibility Act. The Act underscores a zero primary balance and a steady reduction in the overall fiscal balance with the objective of reducing Pakistan's debt/GDP ratio to sustainable levels. Fiscal dominance of monetary policy would remain until the taxation structure is overhauled and there are explicit legal provisions which limit government's recourse to central bank financing that in turn will induce further fiscal discipline while encouraging mobilizing funding requirements from the market.

Legally, SBP has recourse to section 9(A) of the SBP Act which allows the SBP to take a decision, in consultation with the board, on the total government borrowing as specified below:

"the Governor may ….. determine and enforce, in addition to the overall expansion of liquidity, the limit of credit to be extended by the Bank to the Federal Government, Provincial Governments and other agencies ….."

Aside from the need for better understanding in this area, issuance of debt securities has the additional benefit of diversifying debt financing sources by encouraging development of the long term debt market in Pakistan.

[4] Ahmed, Noor & Hastam, Shah & Agha, Asif Idrees and Mubarik, Yasir Ali (2005), "*Transmission Mechanism of Monetary Policy in Pakistan"*, SBP Working Paper Series.

[5] All CPI items are arranged according to their YOY changes in a given month, 20% items showing extreme changes are excluded with 10% of the items at the top of the list and 10% of the items at the bottom of the list. The weighted mean of the price changes of the rest of the items is core inflation.

The impact of monetary tightening on inflation would have been more visible if the government had kept its recourse to central bank financing at manageable levels. Over the last few months, there were concerns that the drift in fiscal management would persist and derail low and stable inflationary trend.[6] The stock of Marketable Treasury Bills held by SBP did rise to over Rs 540 billion but this was brought down to Rs 400 billion as the Government retired a part of its obligations with PTCL proceeds.

Minimizing fiscal dominance is a key pre-condition for an efficient conduct of monetary policy and for enhancing central bank independence.[7]

V. Medium term outlook

In reviewing the monetary policy stance at this juncture, SBP recognizes the potential downside risks to the medium term macroeconomic outlook:

- First, international crude prices remain a potent threat to overall price stability. While the pass-through of international crude prices has been managed well so far, further escalations could immediately endanger the fragile balance that currently prevails between the budget management, oil companies and consumers.
- Second, portfolio switches and liquidity mismatches that have emerged have produced sizeable volatility in reserve money with an upward pressure on money supply, combined with a shortening of maturity of deposits in the banking system. Demand deposits have grown faster than time deposits and certificate of deposits have become an important source of funding for certain banks. These developments warrant continuous and careful monitoring so as to be on guard against the incipient build-up of potential demand pressures.
- Third, continued vigilance is required to examine possible strains on credit quality especially to ensure financial stability and thereby derive synergies with macroeconomic and price stability.
- Fourth, the surge in imports has produced a sizeable expansion in the current account deficit in the first half of FY06 despite a significant of growth of exports. Higher oil prices accounted for 28% of the increase in oil bill and 47% of the increase in external current account deficit. Concurrently, there has been high demand for capital goods, raw material and intermediate goods (including fertilizer, non-ferrous metals and iron and steel) and some of this is expected to help in enhancing industrial capacity utilization. Management of external current account deficit pressures and their non-debt financing would be critical for the next few years. Recognizing this, the foreign exchange reserves would be kept at prudent levels to provide cover for six months of imports.
- Finally, in view of the upward pressures on aggregate demand including pick up in investment activity, a reduction in the revenue deficit and further improvement in the fiscal deficit will add comfort to macroeconomic management.

VI. Inflation targeting

Recently, there has been a proactive debate in Pakistan on alternative monetary policy frameworks - monetary targeting and nominal income targeting versus inflation targeting. Former is questioned because of an unpredictable relationship between money and nominal income and instability in the demand for money.

Advocates of inflation targeting have pointed out to the substantive success across industrialized and emerging market economies of achieving a high degree of price stability. At the same time it is recognized that preconditions for adopting inflation targeting are now evolving in Pakistan, for instance there:

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[6] Draft Paper on *"Is Inflation a Fiscal Phenomenon"*, Economic Policy Department, SBP.

[7] Akbari, Ather H. and Randukwa, Wimal, *"Inflation Targeting in a Small Emerging Market Economy: The Case of Pakistan"* and Khalid, Ahmed M., *"Is Inflation Targeting the Best Policy Choice for Emerging Economies ? A Survey of Emerging Market Experiences and Lessons for Pakistan."*

(i) Exists Legal framework for central bank's operational independence

(ii) Exists Fiscal Responsibility Act which offers an opportunity to impose greater fiscal discipline

(iii) Financial sector is growing and has benefited from privatization of banking system

(iv) Pakistan is now exploiting domestic and international capital markets

Some studies have further recommended that exchange rate would have to be factored in the inflation targeting framework not only to the extent that the inflation forecast is affected by the exchange rate, but also insofar as the SBP may need to adjust the monetary policy instruments to limit the impact of exchange rate changes on other objectives, say, external competitiveness.[8]

There are however concerns that preconditions for Pakistan switching to inflation targeting do not exist and that commodity and import prices are a major determinant of inflation in Pakistan, rather than monetary policy. As has been discussed earlier, there is sufficient evidence and grounds that inflation is a monetary phenomenon too and this will continue to prevail more visibly as the economy further matures. Given the risks and vulnerabilities associated with emerging markets which have good growth prospects but remain prone to a series of shocks (oil prices, export prices, droughts, floods, and so on) a move towards adoption of suitably modified inflation targeting would be in order to prevent the drift in headline inflation rate, as well as their potential reverberations.

It is this consideration, which is motivating SBP to launch development of appropriate data and models to assess the determinants of inflation and to be able to forecast inflation.

Conclusion

In the short-term, while pursuing monetary aggregate, SBP will need to maintain its monetary tightening stance and enhance its communication to influence inflation expectations, and counter concerns about the adverse effects of higher interest rates on competitiveness and/or growth. However it is important to note that monetary policy alone will not be able to contain all the rise in inflationary pressures. In particular, there is an urgent need for the government to supplement its administrative supply-side measures with policies to address market structure problems. Inflationary pressures arising from supply side factors respond more to legal and administrative measures, and are less sensitive to monetary tightening.

Going forward, SBP will be launching preparatory work on inflation targeting. Among others, it will be important for SBP to explore what is an appropriate index to target, whether some components of the CPI should be systematically excluded from or added to the CPI index, what new statistics and refinements in data (including information on stock market indicators and real estate prices) might be needed for developing model and analytical framework for inflation forecasting. There will be need for introducing supportive legal and regulatory framework which allow for targeting inflation and allow greater operational independence to the central bank, while ensuring that SBP has the desired transparency and communication strategy critical for transition to an eventual adoption of inflation targeting.

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8 As discussed in Zaidi (2005).